No. 12660

In The United States Court of Appeals
For the Ninth Circuit

HARBOR PLYWOOD CORPORATION,
a Corporation, *Petitioner,*

vs

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

UPON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

REPLY BRIEF OF PETITIONER

WARREN A. DOOLITTLE,
Attorney for Petitioner.
657-671 Colman Building,
Seattle 4, Washington.

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I.

OBJECTIONS TO RESPONDENT'S STATEMENT OF THE CASE

In two particulars the respondent's statement of the case on p. 4 of his brief is wholly inadequate. First, with reference to Joint Exhibit 7-G (R. 64-71) the respondent refers to this simply as a renewed request by the Treasury Department Price Adjustment Board for information to determine if Pacific's contracts were entitled to clearance or were subject to renegotiation. This was no mere request. It was no form letter. It was a positive statement that Pacific was *not* exempt from renegotiation and that it was subject to renegotiation. Paragraph Two of that letter from the Chairman of

the Price Adjustment Board concluded with an unequivocal directive in these words:

> "Consequently, I am directed to require that your accounts be renegotiated." (R. 65.) (Also see pp. 33-34 of Petitioner's brief).

The second inadequacy in respondent's statement is found in respondent's reference to Joint Exhibit 11-K (R. 77-78). It is true that in this letter to Pacific the Price Adjustment Board stated, in part, that upon review of the information submitted "no further action is contemplated." However, this letter contained two distinct limitations. First, it was limited to the fiscal year ending March 31, 1944 (not 1943 as stated in error—see Joint Exhibit 12-L and 13-M, (R. 79-80); second, it expressly stated that " * * * such cancellation does not operate as a release of liability under the Renegotiation Statute * * * " (R. 78). Therefore, the Tax Court's finding (R. 128, 130), repeated by respondent in its brief at p. 4, that Pacific was sustained in its contention that it was not subject to renegotiation is inaccurate. In short, Joint Exhibit 11-K was not an unconditional clearance for Pacific. By its own terms, no unconditional clearance took effect until the Renegotiation was barred by the statute of limitations. Until this happened, Harbor Plywood had no enforceable claim against Pacific Forest Industries and, hence, no accrued income.

II.

REPLY TO RESPONDENT'S ARGUMENT

A. The Applicable Principles Laid Down by this Court in the *Liebes* Case, Which Remain Unchanged, Support the Taxpayer's Alternative Contention.

The petitioner does not disagree with the respondent's statement (Br. 8) that the right to receive may become fixed both in fact and in amount, although collection of all or part of the amount receivable may be uncertain. So, too, petitioner agrees that future uncollectibility of a fixed amount receivable may give rise to a bad debt deduction at such future time. But does not all of this presuppose that the *amount* of the income which the taxpayer has a right to receive is either fixed and definite or is at least susceptible of ascertainment with reasonable accuracy? The language of the leading case of *Spring City Co. v. Commissioner,* 292 U.S. 182, refers to an "amount" when it says (pp. 184):

> " * * * that it is the right to receive and not the actual receipt that determines the inclusion of the *amount* in gross income. When the right to receive an *amount* becomes fixed, the right accrues." (Italics supplied).

This is certainly language relating not only to an enforceable right but also to a determinable amount.

Both parties agree, by their citation of the language in the *Spring City* case, *supra,* and their citation of this Court's language in the case of *H. Leibes & Co. v. Commissioner,* 90 F.(2d) 932, 937-938, that income accrues when the right to receive an amount becomes fixed if there is a reasonable expectancy that the right will be

converted into money or its equivalent. This being so, it will be seen that it is the Commissioner, and not the taxpayer, who is fallacious in his reasoning.

Substantially all of the cases cited by respondent in part A of his argument (Br. 6-15) were decided before, and were considered and cited by this Court in, the *Liebes* case, *supra,* and appear in that part of the *Liebes* opinion quoted extensively by Petitioner in its brief, pages 14-20. No new cases have changed the rule of the *Liebes case.*[1] Those cases cited and relied upon so enthusiastically by respondent dealt with *amounts* which were either definite (*e.g., Spring City v. Commissioner, supra; Clark v. Woodward Construction* (C.A. 10th) 179 F.(2d) 176, or susceptible of ascertainment with reasonable accuracy (*e.g., Continental Tie & Lumber*

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[1] Since the *Liebes* case was decided in 1937 there have been no new decisions of this Court, of other Circuit Courts of Appeal or of the United States Supreme Court altering the fundamental principles laid down in the *Liebes* case. The principal cases of the higher courts on this subject since 1937 are: *Commissioner v. Lyon,* 97 F.(2d) 70 (C.A. 9th, 1938) involving a lease deposit which might be returnable by the lessor-taxpayer if the lease was terminated otherwise than by default of the lessee, where this Court held the deposit was income in the year of receipt because received without restriction as to its disposition even though taxpayer might be adjudged liable to restore its equivalent; *Franklin County Distilling Co. v. Commissioner,* 125 F.(2d) 800 (C.A. 6th, 1942), concerned with a fixed right to an amount which could be calculated with reasonable accuracy; *Security Mills Co. v. Commissioner,* 321 U.S. 281 (1944), concerned with the propriety of an accrued deduction, rather than accrued income; *Clark v. Woodward Construction Co.,* 179 F.(2d) 176 (C.A. 10th, 1950), discussed hereinafter and emphasiz-

Co. v. United States, 286 U.S. 290; *Automobile Insurance Co. v. Commissioner,* 72 F.(2d) 265 (C.A. 2d); *Franklin County Distilling Co. v. Commissioner,* 125 F.(2d) 800 (C.A. 6th).[2] When the right to receive such an amount became fixed or unconditional, and if there was a reasonable expectancy that such right would be converted into money or its equivalent, it should be accrued, *H. Liebes v. Commissioner, supra.*

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[2] We are not concerned here at all with those cases where income has been received under a claim of right and without restriction as to its disposition, even though it may still be claimed that the taxpayer is not entitled to retain the money, and even though he may be adjudged liable to restore its equivalent, *North American Oil Consolidated v. Burnet,* (1932) 286 U.S. 417; *Brown v. Helvering,* (1934) 291 U.S. 193; *Commissioner v. Lyon,* (C.A. 9th, 1938) 97 F.(2d) 70, discussed *supra,* footnote No. 1; *Security Mills Co. v. Commissioner,* (1944) 321 U.S. 281; 154 A.L.R. 1276 and cases noted there.

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ing that the decisive factor in accruing income is the creation of an enforceable liability; *Commissioner v. Edwards Drilling,* 95 F.(2d) 719 (C.A. 8th, 1938), emphasizing that, though under accrual method of accounting items must be accrued as income when events occur to fix amounts due and determine liability, strained construction in administrative efforts to accrue income should be avoided, and that a taxpayer is under no obligation to accrue income that he may never receive; *Broderick v. Anderson,* 23 F.Supp. 488 (D.C., S.D., N.Y., 1938) citing the "reasonable expectation" rule of the *Liebes* case; *Craig v. Thompson,* 177 F.(2d) 457 (C.A. 8th, 1949)reiterating that the right to receive the income must be fixed and definite and the *amount* thereof must be reasonably determinable; *Clifton Manufacturing Co. v. Commissioner,* 137 F.(2d) 290 (C.A. 4th, 1943) citing and re-emphasizing the sec-

But if the *amount* is not even susceptible of ascertainment with reasonable accuracy, what can be accrued? Nothing. The Commissioner seems to argue that if you have a definite and ascertainable right to an *in*definite and *un*ascertainable amount you have something to accrue.[3] The Tax Court itself (R. 130) attempted without success to escape this dilemma, as Petitioner pointed out in its brief, pp. 36-37. When the Tax Court said:

> " * * * There was no contingency as to the amount of income represented by the credit memorandums or of Pacific's right to receive it; *nor was there any contingency as to petitioner's right to whatever income might remain after renegotiation, should that occur.* The mere possibility of renegotiation did not give rise to a liability which either Pacific or the petitioner could have accrued on its books, since it had not become fixed and was being

[3] If this is not his argument, then he presumes what is not in the record, namely, that the *amount* represented by each credit memorandum when issued "subject to renegotiation" was susceptible of ascertainment with reasonable accuracy before the period of limitations expired on renegotiation. See Argument B-1 hereinafter.

ond half of the *Liebes* rule of reasonable expectancy of collection; *Swastika Oil & Gas Co. v. Commissioner,* 123 F.(2d) 382 (C.A. 6th, 1941) citing the *Liebes* case and relying on its rule that no income accrues unless there is a reasonable expectancy that the right will be converted into money or its equivalent; *Frost Lumber Industries v. Commissioner,* 128 F.(2d) 693 (C.A. 5th, 1942), (1) an item "accrues" when all events have occurred necessary to fix the liability of the parties and to determine the *amount* of such liabilities; (2) "Though the computation may be undetermined, if the

> strenuously protested by Pacific. No liability for renegotiation was set up in Pacific's books. *Conceding that there was a possibility of renegotiation, there was no way of even approximating the amount of excessive profits that might be claimed by the Government.*" (Italics supplied).

it frankly admitted that Harbor Plywood could not ascertain with reasonable accuracy the *amount* it would receive under these conditional credit memos at the time of their issuance and, hence, could not come under the rule of *Continental Tie & Lumber Co. v. United States, supra.* Neither the taxpayer, Harbor Plywood, nor Pacific had in its books of account all of the data from which the *quantum* of the credit could be calculated within reasonable limits. Treasury's Price Adjustment Board here had no mere ministerial task as did the Interstate Commerce Commission in the *Continental Tie* case, *supra.*

The taxpayer wishes also to reply to respondent's reliance on the case of *Clark v. Woodward Construction Co.,* 179 F.(2d) 176 (C.A. 10th, 1950). On page 13 of Respondent's brief appears this quotation from that case:

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basis for the computation is unchangeable (Pacific's was not until limitations had run on renegotiation) and though the exact amount may be unknown, if it is not unknowable, the item in such cases is to be treated, for tax purposes, as accrued income"; (3) in cases of doubt, benefit is given to the taxpayer, *Keasbey & Matison Co. v. United States,* 141 F.(2d) 163 (C.A. 3rd, 1944) citing the *Spring City Foundry* rule. These are the principal Circuit Court and Supreme Court decisions on accrued income since the *Liebes* case and leave its rule unchanged.

> "Where a taxpayer keeps his books and makes his tax returns on the accrual basis, income accrues when all events have accrued from which liability is determined and the liability has become fixed even though payment is deferred to a time in a subsequent year."

The complete quotation of this brief paragraph is and should have been as follows:

> "Where a taxpayer keeps his books and makes his tax returns on the accrual basis, income accrues when all events have accrued from which liability is determined and the liability has become fixed even though payment is deferred to a time in a subsequent year. *The decisive factor is the creation of an enforceable liability.*" (Italics supplied).

(In that case the highway work for the State of Wyoming was both finished and accepted by the State in 1942. The State's obligation to pay was fixed by statute in 1942—only the time of payment was postponed.)

In our case no enforceable liability of Pacific Forest Industries to Harbor Plywood was created by the issuance of the credit memos "subject to renegotiation" and none could arise until the unresolved and intervening legal right of the Government to renegotiate Pacific Forest Industries (to which intervening legal right reference was obviously made by issuing the credit memos "subject to renegotiation") was barred by the statute of limitations. No suit for collection in the courts could have been maintained by Harbor Plywood against Pacific Forest Industries until such periods of limitations had expired (R. 119, 122); therefore, until such time, there could be no accrued income.

B. The Record Supports the Taxpayer's, and Not the Tax Court's, Conclusion.

1. The right to receive the income did not and could not arise in the taxable years when the credit memos were issued.

In part B-1 of his brief respondent contends that the right to receive the income arose in the taxable years (Br. 16-18). In this part of the argument the respondent overlooks or ignores the express finding of the Tax Court that each of the credit memos was issued *"subject to renegotiation"* (R. 128). This finding is amply supported by the record—see Joint Exhibits 6-F (R. 62, 128); 10-J (R. 77, 128); and 3-C (R. 35)—and no assignment of error to such finding has been made by either party. No account receivable arose at the time orders were placed with Harbor Plywood by Pacific. Receivables in favor of the members in ordinary years arose at the time the credit memos were issued. But these years in question were not ordinary years and the memos were, therefore, issued conditionally, *i.e.,* "subject to renegotiation." But so long as that condition was not barred by limitations, the right to receive the income did not arise and could not be accrued. The only thing Pacific was to pay to its members was what was left after all the legal liabilities and expenses, paid or incurred, were determined. So long as Pacific was legally liable to Renegotiation, Harbor's right to the income represented by the conditional credit memos was not fixed and was not unconditional; nor was the amount fixed or susceptible of ascertainment with reasonable accuracy. Unlike the cases of *United States v. Anderson,* 269 U.S. 422 (1926); *Continental Tie & Lum-*

ber Co. v. United States, supra; Clark v. Woodward Construction, supra, all events had not occurred, when the Pacific credit memos were issued "subject to renegotiation", which fixed the amount of the credit or determined the liability of Pacific to pay it; all these events occurred when the period of limitations on Renegotiation of Pacific expired, and not before.

2. The "reasonable expectancy" test of the *Liebes* case was not met.

Replying to Part B-2 of Respondent's brief, arguing that there was a reasonable expectancy of payment of the amounts receivable, the petitioner wishes to advance these points:

(a) There could be no such reasonable expectancy so long as the unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the Statute of Limitations, see Part E of Petitioner's brief.

(b) Such renegotiation was not only possible but highly probable, see Part B of Petitioner's brief. Respondent completely ignores the emphatic language in Joint Exhibit 7-G (R. 64-66):

> "... Consequently, I am directed to require that your accounts be renegotiated."

and also disregards the fact that such threats were actual, strong, continuous and definite (R. 57, 64, 70, 77), that they were not mere requests for information. Respondent also completely disregards the fact that these threats were made not only by letter but also by official statements in personal conferences with the

Treasury Department attended by counsel and general manager of Pacific (R. 111-114), who endeavored without success at these conferences to obtain an unconditional clearance for Pacific from renegotiation (R. 111). The only clearance obtained by Pacific, namely, the letter from Treasury Procurement dated June 21, 1944 (R. 77-78), was clearly conditional in its terms: it was limited to Pacific's fiscal year ending March 31, 1944 (not 1943) and did "not operate as a release of liability under the Renegotiation Statute."

(c) The fact that Pacific was never actually renegotiated is irrelevant. It is viewing the matter, as the Commissioner is all too often prone to do, with hindsight and not foresight. At the time the credit memos were issued and the decisions as to accrual were made in good faith who could say there would be no Renegotiation? In cases of doubt, benefit is given to the taxpayer, *Frost Lumber Industries v. Commissioner, supra.*[1] Nor is it correct, as the Tax Court states (R. 130) and as Respondent argues (Br. 20), that Pacific was sustained in its contention of being free from Renegotiation. The letter of June 21, 1944 (R. 77-78), referred to above, did not unconditionally sustain such contention. Strained construction in administrative efforts to accrue income should be avoided, *Frost Lumber Industries v. Commissioner, supra.*

3. The *Liebes* case alone justifies reversal; respondent did not, and can not, logically demonstrate its inapplicability here.

Replying to Respondent's argument B 3, that none of the cases cited by the taxpayer furnish a basis for

reversal, the petitioner submits that the Respondent's attempt to point out the inapplicability of the *Liebes* case, *supra,* was to no avail. Respondent again ignores the fact found by the Tax Court that all credit memos were issued "subject to renegotiation." True, it was Pacific and not Harbor Plywood, the taxpayer, who was disputing and "litigating," as it were, the Renegotiation question and it was subject to such dispute and litigation that the credit memos were issued. Hence, by incorporating such condition by reference into the credit memos, the taxpayer's position here actually was like the taxpayer's position in the *Liebes* case. To hold otherwise is to make the same error in logic that the Tax Court made as to the patronage dividend argument (see Petitioner's Brief, p. 40-41), namely, it would raise the taxpayer, Harbor Plywood's, right to such income to a higher degree of certainty and to a more reasonable degree of expectancy and would find the amount thereof susceptible of a more accurate ascertainment, than the source of such income. This, of course, is a logical absurdity. Hence, the *Liebes* case is not, in fact, distinguishable in principle; instead, the *Liebes* case alone justifies reversal.

4. The *Lester Smith* case, 8 T.C.M. 385 (1949), is applicable by way of analogy.

Replying to B 4 of Respondent's argument, petitioner recognizes that it is an accrual basis taxpayer and that cases dealing with "constructive receipt" by cash basis taxpayers are not squarely in point. Such "constructive receipt" cases, as stated in part D of petitioner's brief (Br. 41-42) and elsewhere (Br. 28-

31) are, however, persuasive by way of analogy. It requires no citation of authority to support the proposition that analogy has played a strong role in the evolution of case law. The petitioner can find no case dealing squarely with the Renegotiation problem confronting the accrual basis taxpayer before this Court and Respondent has cited no such case. This Court will have to apply established principles, and perhaps reason, in part, by analogy to determine the correct result in the case at bar. As an aid in arriving at such result the petitioner cited and discussed at length the case of *Lester C. Smith, Mary B. W. Smith v. Commissioner,* 8 T.C.M. 385 (1949) dealing with the Renegotiation (under the same Renegotiation Act of 1942 involved in the case at bar) of an employer and the impact of such Renegotiation on the "constructive receipt" of income by an employee, a cash basis taxpayer, whose income from compensation was "subject to renegotiation." (See Petitioner's Brief, p. 28-32, 41-43).

Petitioner again respectfully invites the attention of this Court to the fact that the Tax Court refused to consider or even mention such case (notwithstanding that it was cited and argued extensively in the Tax Court briefs) and the Respondent has followed suit by ignoring this *Smith* case completely without any attempt to distinguish it. I am sure this Court will agree that the *Smith* case presents a persuasive argument by way of analogy in support of Petitioner's position.

III.

CONCLUSION

In view of the foregoing facts and the arguments advanced in petitioner's opening brief and in this Reply brief, petitioner prays that the Tax Court be reversed and that it be directed to enter an order in this case of either (1) "No deficiency"; or, in the alternative, (2) to compute the correct deficiencies, if any, for each of said years in question in accordance with the decision of this Court that the amounts represented by the credit memoranda issued by Pacific Forest Industries to Harbor Plywood Corporation were taxable to Harbor Plywood Corporation and should have been accrued by it as taxable income in the years when the statute of limitations barred Renegotiation of Pacific Forest Industries, and not before.[4]

Respectfully submitted,

WARREN A. DOOLITTLE
Attorney for Petitioner

February, 1950

[4] The deficiencies of tax owing under this second alternative have already been agreed to between the parties (R. 29-30).